DOW THEORY LETTERS INC.

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THE MARKET: Everyone who has been in the market for the past 3 to 5 years or longer (during the great bull market) is familiar with the typical bull market reaction. The market is advancing in harmony with the primary bull trend. As the advance progresses volume starts climbing, and after a period of a few months or longer trading becomes active, then speculative, and finally the market begins to boil. What is occurring? Higher prices are stirring the imagination of the "Johnnie-come-lately" and the amateur trader. Everyone is talking about "easy profits" in the market, and the little old lady next door is telling you about the 62 shares of "International Skyrocket" which she bought only a month ago for 6 and now it is 12. Everybody is in on the act, and you find yourself staring at the quotes of International Skyrocket yourself. Then it happens: the "safety valve" of the market is released, and a violent reaction occurs. In a few weeks 1/3 to 1/2 of the gains of the whole rise are erased. All the amateur speculators and late-comers are hurt. The excesses of the advance are burned away. But it's a primary bull market, and following the reaction the Averages plod doggedly upward. Ultimately (despite temporary damage) new highs are reached.

The action during a bear market is generally faster and more violent than that of a bull market. But basically, the underlying price mechanism works in the same way. Stocks are declining in the bear market in harmony with the primary bear trend. As the decline progresses the downside action becomes more violent and more spectacular. The little grandmother next door is now telling you about the 16 shares of Fairchild Camera which she sold short only last week at 152. Today it is 116. It all seems so easy, so fast, so profitable! Maybe you can still jump in and short a few shares of Fairchild yourself. Each day brings new lows in the Averages. The market is "going to pot." Then it happens: within a few days the Dow is up 30 points. The short sellers are running for the exits. Grandma is trying to cut her losses now, and many people are hurt both on the long and the short side.

But there is an important difference in psychology during a bull and bear market. Wall Street is normally bullish, and it is a truism that the Street makes its living from the bull side. A bull market breeds optimism, volume and profits. A bear market generates pessimism, shrinking volume and losses. Therefore, during bear rallies the investment fraternity is (understandably) quick to turn hopeful. Each violent rally in a primary bear market is taken to be "the start of a new bull market" -- or at worst, the beginning of "a major upward correction." Near the final end of a bear market, however, that

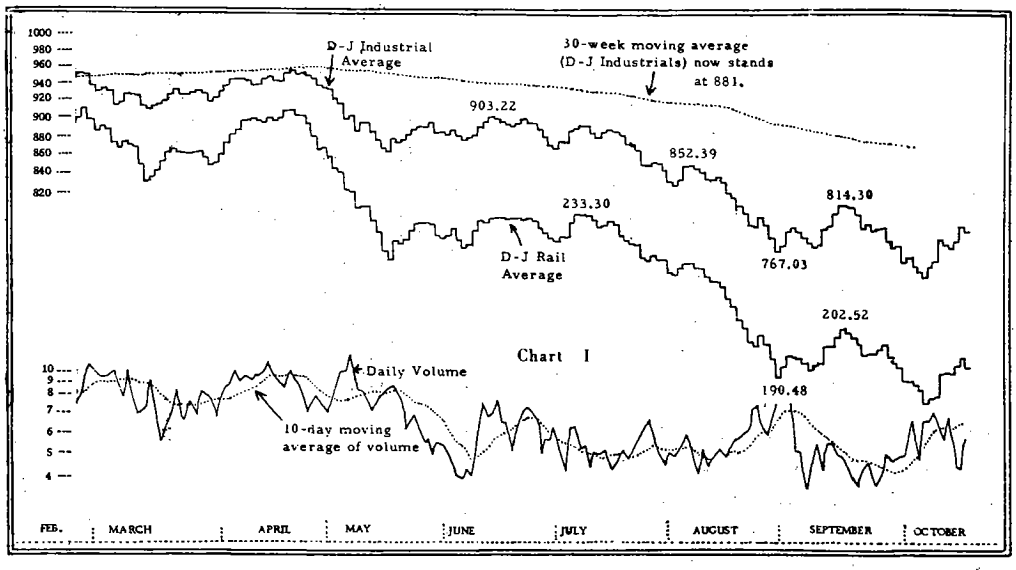
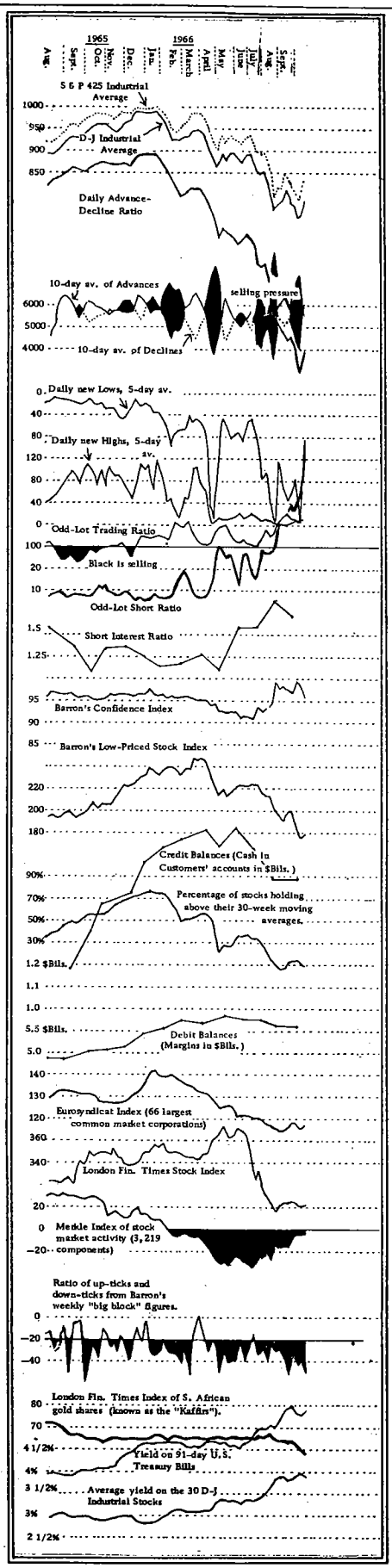


Chart I


1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

psychology will change. Towards the end even Wall Street will be sceptical of the rallies. At the final lows almost everyone will have been hurt, and those who have sold out won't care (perhaps they are even hoping for it) if the Dow goes to zero.

This bear market started at 995.15 on February, 8 months ago. Since then the short sellers have had a picnic, and the stockholders have had a nightmare. Gradually, as the market violated level after level, the short sellers have gathered courage. After all, they have been correct, and each new break has piled up their profits. Short selling has almost seemed too easy. You put out your shorts, and in a month or so you've made 20% to 50% on your money.

In October, the short side of the market began to boil. The previous daily odd-lot short sale record was 41 thousand recorded during June 5, 1962. On October 4, 1966, this record was broken when odd-lot shorts rose to 44 thousand. On October 7 shorts jumped to 45 thousand. Then on October 10 a new record of 56 thousand was recorded. The short side was obviously being overdone. The little odd-lot short speculator was finding the pickings too easy. He was overdue for a "lesson" in moderation. On October 7 the Dow touched a bear market low of 744.32 (Rails 184.34). Then, within the space of 7 trading days, the Industrials roared up 47 points. It was enough to give an odd-lot short seller heart failure. In a few cases, it probably did.

NOTES AND QUOTES: From "contrarian" Humphrey B. Neill's letter of Contrary Opinion (October 12): "A provoking query was posed by a good friend and contrarian as he left the CO Forum a week ago Saturday: 'Is the time at hand when everybody will be gloomy - and everyone will be right?' First let me say that everybody is far from gloomy at the moment. Strangely, the bearishness has not permeated the 'people' - the Crowd is still buying stocks and sampling new automobiles and colored TV's. The guy-on-the-street, whom researchers talk about, is not yet ready to throw in the sponge. Women complain about high prices, but no buyers' strike, because of HCL, has shown up thus far.

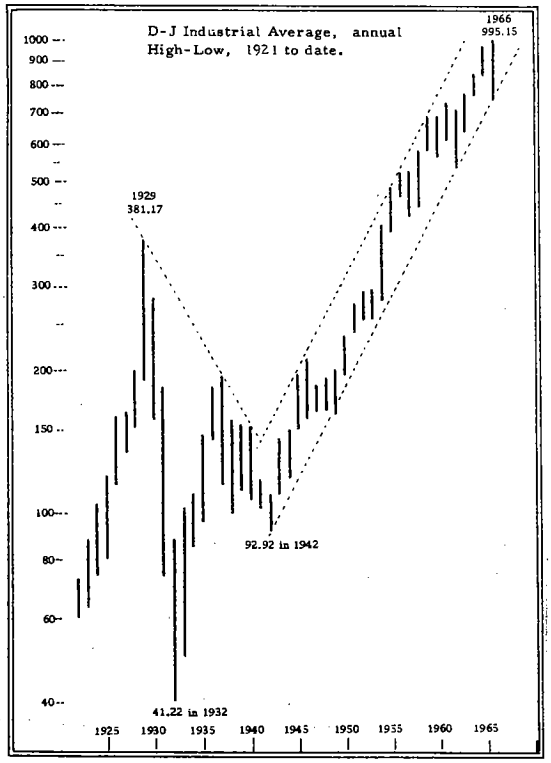
"I think it is safe to say that by the time everybody IS gloomy, the stock market will probably have made 'bottom' and again be on the way up. It is the lack of gloom among the Crowds that has bothered me during recent weeks and has argued for a cautionary attitude toward the economic and financial outlook."

In his Janeway Service of October 11, economist Eliot Janeway warns that Russia may be preparing for a "second front" by entering into the potentially explosive situation in Greece. He concludes his report as follows: "Dollar Run. Militarily, the eruption of a second front, and the switching of a supposed ally or neutral in time of war, must come as a shock. Not so the run on the dollar, which, before very many months, will drain off our so-called 'free' gold reserve and force Johnson to decide whether to embargo further shipments or, instead, to take the initiative in freeing the domestic note issue from its present artificial legal gold cover. The outside world is right to suppose that, if the U.S. can afford to finance the enormous burden of Vietnam, she cannot afford not to make the dollar unassailable. The rate at which the military crisis and the financial crisis are getting into gear is more alarming to us than any single difficulty on the horizon - even more so than the danger that Russia may wind up playing her hand against us on NATO's eastern flank just when we are playing our next hand against North Vietnam and when Europe is playing her hand against the dollar.

"Altogether, the stock market has been realistic not to attempt a serious rally: we don't expect the one which started this week to undo very much damage - even as a bear market rally. As for the bond market, it did not enjoy its premature and wishful rally for very long before it collided with the reality that Presidential P.R. tokens are not substitutes for the action which is still wanting."

Did October 10 mark the beginning of a new bull market? In my humble opinion, it did not. Could it be the start of the full upward correction alluded to in the last Letter? It could be, but as of now there is no way of telling. During bull market reactions a period of base building (often "double bottoms") can be expected. But during bear market rallies bases often do not appear. Thus of the 8 upward correction which occurred during the great 1929-32 bear market, only 4 were preceded by anything which could be termed bases or "double bottoms." The rest were straight-up affairs, providing little chance for the conservative trader to assume a "safe" position.

I expect this bear market to be every bit as deceptive as previous bear markets, and I expect scalping operations (on both the long and short side) to be every bit as difficult. Therefore, I continue to advise a cash position (or 91-day Treasury bills) while this frantic, wildly gyrating bear market goes through its paces. Remember, as I stated in Letter 334, the only safe time to speculate during a primary bear market is for the recovery following a true crash-panic. This type of rare action has not occurred (so far) during this bear market. However, I believe that in due time we will see this market crash. Following almost every crash in market history, there has been an "automatic" recovery in which the Averages regained at least 1/2 of the losses sustained during the crash. In the absence of such action I recommend (1) getting out of all stock positions, both long-term and short-term, (2) refraining from all trading operations.



WHERE IT STOPPED: I have drawn what I believe is a rather fascinating picture of the D-J Industrial action over the past 45 years. The chart includes annual high-lows (closings) for the Dow, and the chart is drawn to semi-logarithmic scale. Because of the semi-logarithmic (ratio) scale all movements are properly shown in percentages. In other words, a movement from 40 to 80 on this chart shows up as exactly the same vertical distance as a movement from 200 to 400. This is as it should be since each movement represents a 100% increase in price.

On this annual high-low chart, it would appear that the entire rise from 1942 to 1966 is part of one single, incredible upward thrust. Even more amazing is the fact that the whole rise appears to fit so perfectly within the confines of a long ascending channel.

Despite the single-channel effect, a good case can be made for the rise from 1942 having contained two separate bull markets, 1942 to 1946, and 1949 to 1966. At any rate, here are some of my observations regarding this "big picture." If the trendline which connects the 1942 to 1962 bottoms is drawn (and this is the lower trendline of the channel as shown on the chart), that trendline would meet the Dow on any decline to 740. In other words, any movement below 740 on the Dow would rupture a trendline which has held for 24 years through 2 bull markets.

On October 7 the Dow closed at a 1966 low of 744.26. On October 10 Dow-Jones quoted an extreme inter-day (not closing) low for the Dow of 735.74. Did October 10 break the trendline? Perhaps, but I would prefer an actual closing price decisively below 740 before I would say that this 24 year trendline was broken. At any rate, the most recent rally (which started from the October 7 low) did begin from the major trendline as pictured on this chart.

It seems to me that if any future decline results in a decisive closing violation of the 740 level, we will have something of great significance from a technical standpoint. Such a closing (say 725) would mean that for the first time since 1942 the 24-year old trendline has been shattered. And after all, this trendline is the technical factor which has held bullishly intact longer than all others. It is the longest-term (and therefore the most powerful) bullish technical phenomenon on Wall Street.

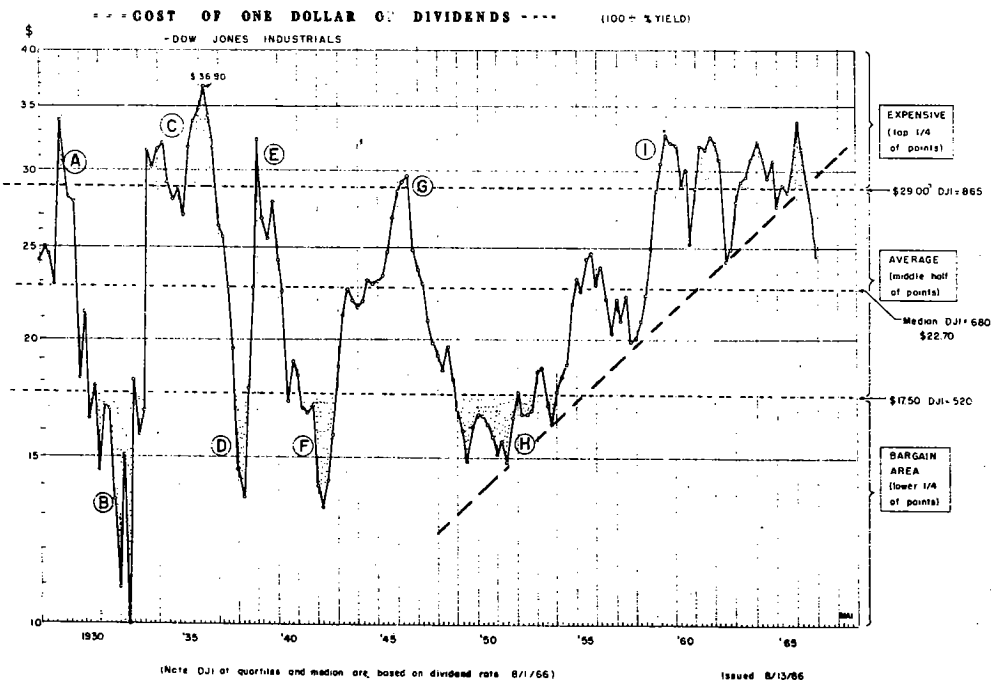
Of some interest is the fact a second major trendline can be drawn on this chart. This is the trendline which connects the 1949 (when the current bull market started) and the 1962 bottoms. The 1949-66 trendline stands at approximately 760-770 today. Obviously, the recent low has shattered that trendline, and I take this to be a bearish factor for the market. For on a log-scale chart starting in 1949, the two lowest points through which a trendline can be drawn are the 1949 and 1962 bottoms. That trendline is no more.

CONCLUSION: The last great ascending trendline of the 1949-66 bull market has been violated. Only one more benchmark remains, and that is the grand trendline connecting the 1942 and 1962 bottoms. If that trendline is broken, the upward thrust of the past 24 years will have been reversed and the last doubts regarding the major import of this bear market will have been removed.

YIELD: Subscribers are sometimes surprised at the prominence which I accord to average stock yields. Yet yields have played a time honored role in Dow Theory interpretation. Charles Dow himself constantly referred to stocks as fluctuating between extremes of "great values" (i.e. high yields) and "little value" (i.e. low yields). "When a stock sells at a price which returns only about 3½% on the investment," wrote Dow, "it is obviously dear, except there be some special reason for the established price." It is perhaps no accident that every bear market in history started with average yields on the Dow in the 3% or less yield zone. By the same token, most bull markets have started with the average yield on the Dow stocks in the 6% or better zone.

A friend of mine here in San Diego runs a stock market service ("Value Trends") which utilizes the yield concept as an integral part of his service. Recently he explained the yield concept so well that I have decided to include that explanation in Dow Theory Letters. I suggest that subscribers study the following carefully.

"Dividends meet the most basic of all investment fundamentals, income. The underlying value of dividends will in the long run establish price. A consistently rising dividend trend best reveals a company's profitable progress. Further, the trend of dividends is usually more reliable and less erratic than the trend of earnings. Earnings are subject to such bookkeeping vagaries as depreciation, cash flow, inventory adjustments, reserves and tax considerations. A long-dividend paying, high-quality, 'blue chip' type stock rarely cuts dividends even in periods of cyclical stress. Such stress normally depresses the price of the stock excessively, which produces an extreme of high yield. The combination of low price and high yield



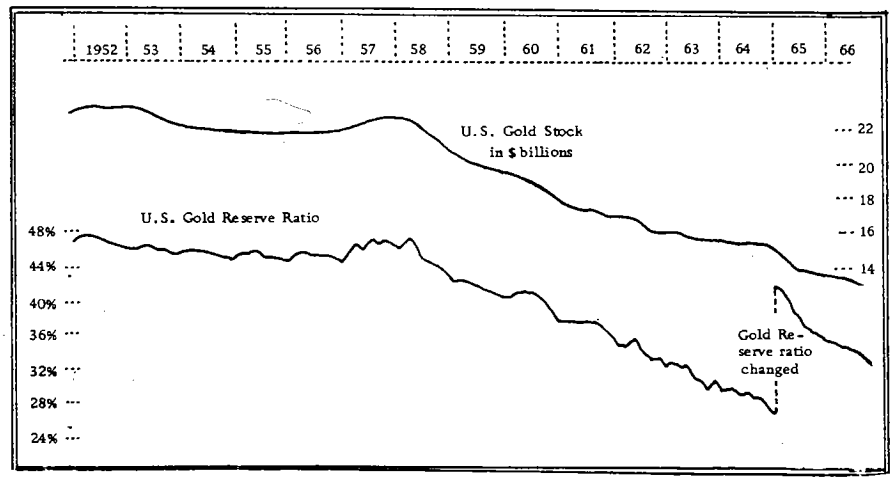
 provide the ingredients for basic investment value."

Dow was one of the first to call attention to the yield cycle, the fact that yields tend to move in broad extended sweeps --from one extreme to the other. Documenting Dow's observation is the accompanying chart showing the cost of one dollar of dividends. The chart covers the period from the mid-1920's to the present . (Chart courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y.). To arrive at the cost of one dollar of dividends, 100 is dividend by the yield, which means that this chart is simply another way of prese: ing the yield cycle.

The chart shows five major extremes of overvaluation (low yields) in the past 40 years, and these are lettered A, C, E, G and I on the chart. By the same token there have been four areas of great values and these are lettered B, D, F and H on the chart. Note that the latest overvaluation zone has assumed the form of a massive "four-peak top." I have drawn a trendline which ascends from H and connects the 1958 and 1962 bottoms. It is obvious that the trend of rising yields which began in 1951 (H) has now been totally ruptured.

This reversal of the yield trend corresponds with the inception of a major bear market. According to the Dow Theory, the next major overall direction of yields should now be to undervaluation. To put it another way, before the current bear market ends stocks should be down in the "bargain area" as marked on the chart. At the bargain area yields on the Dow can be expected to average 6% or more. Good growth stocks and blue-chip shares purchased in such bargain areas have, in time, made fortunes for their holders. But the key now is patience. There is many a slip (and costly mistake) between the early part of a bear market and the final bottom. The true investors possess the patience and strength of character to wait for the final bottom.

CHART OF THE WEEK: The Federal Reserve System originally decreed that Federal Reserve Deposits and Currency should be backed by gold. Starting with a "gold ratio" of 35% (Deposits) and 40% (Currency), the ratios were dropped to 25% during the 1940's. In early 1965, as the gold ratio dropped to a crisis level of 27%, the gold clause was removed from Deposits (it was applied only against the Currency). This adjustment is seen on the accompanying chart. But note that the ratio has been declining rapidly, and as of last week the ratio had slid from its February, 1965 adjusted ratio of 40% to (an October, 1966) low of 32.8%. The ratio is now about 5% above the 27% level which required action during 1965. If the ratio continues to slide (and there is no reason to believe that it will not), we can probably expect another gold crisis within a year. It is for this reason that I continue to believe that our 10% to 15% (of total assets) hedge in gold shares is desirable.



LATE OBSERVATIONS: Positive short-term indications are (1) Uptrends in Utilities and Bonds. (2) Record odd-lot shorting. (3) Upward zig-zags in the Industrial and Rail Averages. Bothersome indication is the odd-lot picture of the past few months. Normally, a good bottom is accompanied by a definite trend towards odd-lot selling (or less buying) as the market declines. This relationship was absent at the October lows. Therefore, it would not surprise me to see a coming sharp (even "scary") decline during the period ahead--this decline to be accompanied by a definite switch to less odd-lot buying or even selling on balance. Such an indication (remember the October, 1962 sell-off following the June, 1962 bottom?) would present a much more reliable picture of potential strength and a possible full correction of the entire February-October collapse to stem from this area. This is not to imply that we are now in fact in the full correction phase alluded to in the last Letter. But if there is to be a full correction starting from the October lows, I would think it should be signalled (among other things) by a declining Industrial Average in the face of odd-lot selling.

STOCKS: Downside resistance to decline is being evidenced by a number of better-grade stocks, while the majority of lesser quality and secondary issues still have retained that "shredded" or "ripped asunder" look. I have included two weekly charts to illustrate what I mean. Here we see Gen. Foods beginning to show potential "basing" action. At worst we can say that Foods has lost its downside momentum. On the other hand Gen. Steel Ind. still possesses the "plunging" look and there is little here to suggest downside resistance in this stock. I count 8 of the 30 Dow stocks as showing superior relative strength at this point, and they are Proctor & Gamble, Owens-Ill., Texaco, Am. Tel., Gen. Foods, Gen. Motors, Standard Oil of Calif., Stand. Oil of Jersey. (Charts courtesy of Quote Digest, 110 N. Lorraine, Wochita, Kansas).